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BRIEF

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Are Microcredit Interest Rates Excessive?

Over the past two decades, institutions that make microloans to low-income borrowers in developing and transition economies have focused increasingly on making their operations financially sustainable by charging interest rates that are high enough to cover all their costs. They argue that doing so will best ensure the permanence and expansion of the services they provide. Sustainable (i.e., profitable) microfinance providers can continue to serve their clients without needing ongoing infusions of subsidies, and can fund exponential growth of services for new clients by tapping commercial sources, including deposits from the public.

The problem is that administrative costs are inevitably higher for tiny microlending than for normal bank lending. For instance, lending $100,000 in 1,000 loans of $100 each will obviously require a lot more in staff salaries than making a single loan of $100,000. Consequently, interest rates in sustainable microfinance institutions (MFIs) have to be higher than the rates charged on normal bank loans.

As a result, MFIs that claim to be helping poor people nevertheless charge them interest rates that are substantially higher than the rates richer borrowers pay at banks. No wonder this seems wrong to observers who do not understand, or do not agree with, the argument that MFIs can usually serve their poor customers best by operating sustainably, rather than by generating losses that require constant infusions of subsidies.

In today's microfinance industry, there is still some debate about whether and when long-term subsidies might be justified in order to reach particularly challenging groups of clients. But there is now widespread agreement, within the industry at least, that in most situations MFIs ought to pursue financial sustainability by being as efficient as they can and by charging interest rates and fees high enough to cover the costs of their lending and other services.

Nevertheless, accepting the importance of financial sustainability does not end the discussion of interest rates. An interest charge represents money taken out of clients' pockets, and it is unreasonable if it not only covers the costs of lending but also deposits "excessive" profits into the pockets of an MFI's private owners. Even an interest rate that only covers costs and includes no profit can still be unreasonable if the costs are excessively high because of avoidable inefficiencies.

High microloan interest rates have been criticized since the beginning of the modern microfinance movement in the late 1970s. But the criticism has intensified in the past few years, and legislated interest rate caps are being discussed in a growing number of countries. Part of the reason for the increased concern about rates is simply that microfinance is drawing ever more public attention, including political attention. Another factor is that quite a few MFIs are now being transformed into private commercial corporations.

In the early years most MFIs were ownerless not-for-profit associations, often referred to as nongovernmental organizations (NGOs). If an NGO generates a profit, the money normally stays in the institution and is used to fund additional services and benefits for clients. But

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many NGO MFIs have eventually wanted to add deposit-taking to their activities, because they see savings services as valuable for their clients, and because capturing deposits allows them to fund expansion of their microlending. When NGOs approach a government banking authority for a license to take deposits, they are usually required to reorganize their businesses into for-profit shareholder-owned corporations. Once this happens, profits can wind up in the pockets of private shareholders, inevitably raising the specter of such owners making extreme returns on their investment by charging abusive interest rates to poor borrowers who have little bargaining power because their other credit options are limited.

A firestorm of controversy erupted in April 2007 when shareholders of Compartamos, a Mexican MFI with a banking license, sold a part of their shares in a public offering at an astonishingly high price, which made some of the individual sellers instant millionaires. One important reason for the high price was that Compartamos was charging its clients very high interest rates and making very high profits. The annualized interest rate on loans was above 85 percent (not including a 15 percent tax paid by clients), producing an annual return of 55 percent on shareholders' equity.

In fact, most MFIs charge interest rates well below those that provoked controversy in the case of Compartamos. But the story tapped into a deep well of concern about high microcredit interest rates and the trend toward commercialization of microfinance.

Are microcredit rates abusively high? Obviously there can be no one-size-fits-all answer to this question, not only because there are huge variations in the interest rates and related circumstances of individual MFIs around the world, but also because there is no agreed standard for what is abusive. There is an intense dispute about how high interest rates and profits would have to be to qualify as "excessive," and indeed about whether terms like this have any useful meaning, at least in the arena of for-profit microfinance. In a recent CGAP study, we did not propose any theoretical framework or benchmark against which to measure what is excessive or not. We presented available data, and then formed our own admittedly intuitive judgment about the reasonableness of the general picture appearing in that data. Of course, readers will apply their own criteria or intuition to the data in judging whether rates or profits strike them as "abusive," "exploitative," "excessive," "unreasonable," etc.

CGAP analyzed the level and trend of microcredit rates, and compared these rates with other rates that low-income borrowers pay. Then we "decomposed" MFI interest income, looking at the levels of its four main components: cost of funds, loan loss expense, administrative cost, and profit. Finally, we briefly considered whether emerging competition can be expected to lower rates in the future.

Interest rate levels

- Based on the best data available, the median interest rate for sustainable (i.e., profitable) MFIs was about 26 percent in 2006. The 85 percent interest rates that drew so much attention to the Mexican MFI Compartamos are truly exceptional, rather than representative of the industry. Less than 1 percent of borrowers pay rates that high.
- MFI interest rates declined by 2.3 percentage points a year between 2003 and 2006, much faster than bank rates.

Comparison with other rates paid by low-income borrowers

- MFI rates were significantly lower than consumer and credit card rates in most of the 36 countries for which we could find rate indications, and significantly higher than those rates in only a fifth of the countries.
- Based on 34 reports from 21 countries, MFI rates were almost always lower—usually vastly lower—than rates charged by informal lenders.
- MFI rates were typically higher than credit union rates in the 10 countries for which data were found. But in the cases where the credit unions offered a specialized microcredit product, their interest charges tended to be the same as, or higher than, prevailing MFI rates. However, it is hard to make much of this information, not only because the sample size is so small, but also because we know little about the comparability of customers and products.

Cost of funds

- MFIs have to pay more than banks pay when they leverage their equity with liabilities, and their cost of funds as a percentage of loan portfolio (about 8 percent) showed no sign of dropping in 2003–2006. But it is hard to criticize MFI managers for their funding costs, because they don't usually have much control over these costs, in the medium term at least.

Loan losses

- MFI interest rates are not being inflated by unreasonable loan losses. In fact, default rates are very low—about 1.9 percent in 2006.

Administrative expenses

- Tiny loans do require higher administrative expenses, which are not substantially offset by economies of scale. On the other hand, the learning curve of MFIs as they age produces substantial reductions.
- Administrative costs, at about 11 percent of loan portfolio in 2006, are the largest single contributor to interest rates, but they have been declining by 1 percentage point per year since 2003. This decline appears to be a true improvement in the cost of serving each borrower, not just the result of expanding loan sizes.
- We have no statistical way to quantify how much avoidable fat remains to be trimmed from MFI operating costs. Given the finding about the learning curve—i.e., that the level of these costs is strongly related to the age of the MFI—it would be unrealistic not to expect substantial inefficiency at a time when most MFIs are relatively young, and when most national microfinance markets are immature and noncompetitive. We are unaware of any evidence to suggest that MFIs in general are out of line with the normal evolution of efficiency for businesses in such markets.

Profits

- MFIs on average have higher returns on assets than commercial banks do, but MFIs produce lower returns on equity for their owners. The median return on MFI owners' equity in 2006 was moderate—12.3 percent, roughly 4 percent lower than the return for banks. The very high profits that have drawn so much attention to Compartamos are outliers, not at all typical of the industry.

- At the same time, the most profitable 10 percent of the worldwide microcredit portfolio produced returns on equity above 34 percent in 2006, a level that is no doubt high enough to raise concerns about appropriateness for some observers. Much of this profit is captured by NGOs and never reaches private pockets. But some of it does go to private investors. A judgment about whether such profits are "abusive" would depend, not only on the observer's standard for what is a reasonable profit, but also on investigation of individual MFI circumstances, including the risk levels faced by investors when they committed their funds.
- Profits of sustainable MFIs, measured as a percentage of loan portfolio, have been dropping by about one-tenth (0.6 percentage points) per year since 2003.
- Profits are not a predominant driver of interest rates. For the median MFI, the extreme and unrealistic scenario of complete elimination of all profit would cause its interest rate to drop by only about one-seventh. Such an interest reduction would not be insignificant, but it would still leave microcredit rates at levels that might look abusive to politicians and the public, neither of whom usually understand the high costs that tiny lending inevitably entails.

Competition

- One cannot assume that competition will always lower interest rates. Interest rates do appear to have dropped in the markets where microcredit has already become competitive, except in Bangladesh. But it is still too early to make any robust prediction about how universal the lower-interest-rates-through-competition scenario will be.

How all this information is put together is up to each reader. We approach the issue from a development perspective, where the main concern is not financial results but rather client benefit—including, of course, those future clients who will get access to financial services as new investment expands the outreach of MFIs. A few MFIs have charged their borrowers interest rates that seem considerably higher than what would make sense from this perspective. Indeed, it would be astonishing if this were not the case, given the diversity of the industry and the scarcity of competitive markets yet.

The real question is whether unreasonable MFI lending rates are more than occasional exceptions. We do not find evidence suggesting any widespread pattern of borrower exploitation by abusive MFI interest rates. We do find strong empirical support for the proposition that operating costs are much higher for tiny microloans than for normal bank loans, so sustainable interest rates for microloans have to be significantly higher than normal bank interest rates. We find a general pattern of moderate profits for MFI owners. Finally, we find that interest rates, operating costs, and profits have been declining quite rapidly in recent years, and we would expect this trend to continue in the medium-term future.

This Brief is a summary of "The New Moneylenders: Are the Poor Being Exploited by High Microcredit Interest Rates," by Richard Rosenberg, Adrian Gonzalez, and Sushma Narain (Washington, D.C.: CGAP, 2009).

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